The McValue Portfolio Newsletter

September 2009

"[Intrinsic Value is] an all-important concept that offers the only logical approach to evaluating the relative attractiveness of investments and business. Intrinsic value can be defined simply: It is the discounted value of the cash that can be taken out off a business during its remaining life." Warren Buffett – 1999 Annual Letter to Berkshire Hathaway Shareholders

Friends,

In the past I have often shared with many of you the details and timing of my latest stock picks knowing that you are all "over 21" and can make your own investment decisions. Some have occasionally followed my lead with what I hope have been satisfactory results although my record has been far from perfect. Rather than continue to informally provide you with my latest thinking on the subject, I decided that it was time to start to put my thoughts on paper for several reasons.

First and foremost, it is easy to proclaim that one is a good investor by talking about the winners and conveniently changing the discussion when it comes to the losers. At the suggestion of a friend (thanks Charlie!), my hope is to create an objective long-term record of my progress for better or worse. Nothing focuses my mind better than the risk of looking foolish in front of people who I like and respect. Secondly, over the years I have discovered a successful investment framework - Value Investing - and wanted to pass along some of what I have learned (don't worry – I won't show up at your door on a weekend with briefcase in hand). My "mentors" on the subject (Graham, Dodd, Fisher, Munger, Buffett, etc.) have been more than generous with their thoughts and all that my investment education cost me was a few hundred bucks in books at Amazon.com and photocopying at Kinkos. Finally, I find that writing things down helps to clarify my thinking when it comes to investing.

Value Investing

One of Canada's most prominent and successful investors has said to me that there is more than one way to make money in the market. While that may be true, I have found Value Investing to be a framework that works for me as it is based on common sense and solid logic. A recent Standard & Poor's study showed that less than 8% of Canada's professional money managers beat the S&P/TSX Composite Index over a five year period. A disproportionate number of those star performers are talented value managers. Unless a money manager can beat the benchmark over a period of time there is no reason for them to exist. You would be better off buying a low-fee index fund.

The reality is that most people with day jobs don't have the time to invest properly or the desire to try. However, even for those that do, there are pitfalls. I believe that many well-meaning but misguided analysts, portfolio managers and investment advisors continue to focus on the wrong things. For example, some "investors" (and I use the term loosely) focus on market timing and technical analysis both of which I generally ignore.

I think that I have given away more that a dozen copies of the best book on investing ever written – Benjamin Graham's *The Intelligent Investor* - but have yet to have even one recipient take to the subject. Most find the subject matter about as exciting as watching paint dry (*Hint: just read Chapter 8 regarding "Mr. Market" and Chapter 20 about Margin of Safety*). Given my failure at converting these recipients, I promise to keep my letters light.

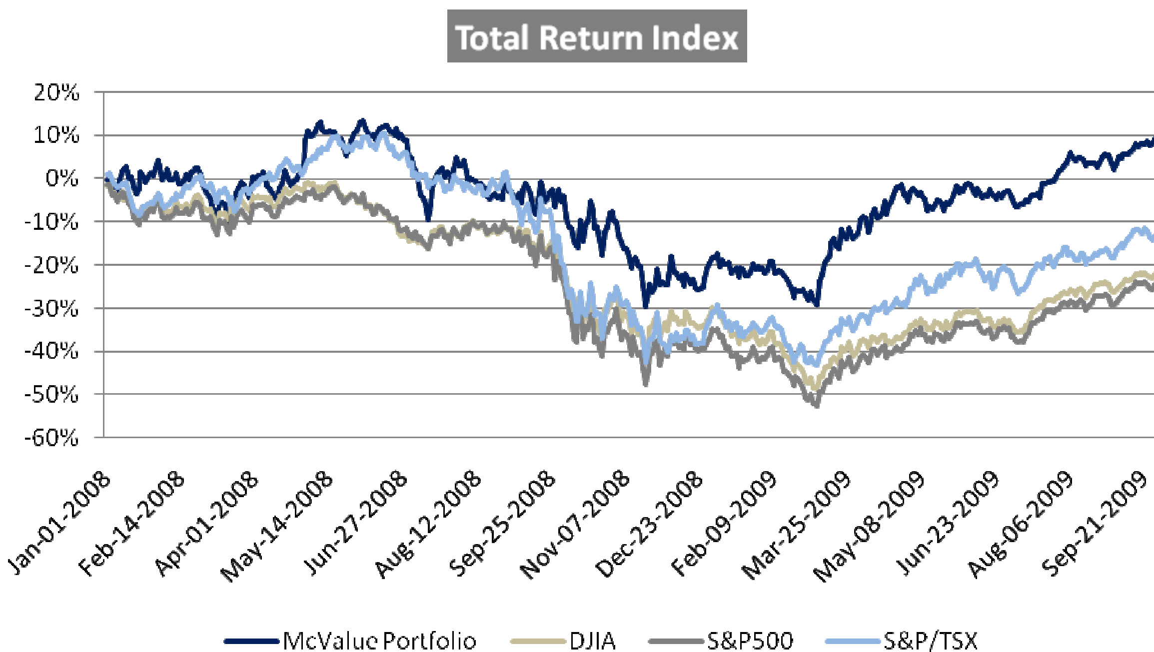
On that note, let's start off with the fundamental concept. Value Investing is all about buying an interest in a quality business for less that its Intrinsic Value. An excellent definition of Intrinsic Value is reproduced in the margin of the prior page. Intuitively the Intrinsic Value concept makes sense. When investing, you are giving up a dollar of consumption today in exchange for a future payout that is expected to be higher to compensate you for inflation and the investment risk you are taking.

The key steps involved in Value Investing are identifying businesses that you can understand, that possess attractive underlying economics, being run by competent and shareholder-friendly management teams. These attributes should allow you to predict future results using conservative estimates and come up with a reasonable estimate of Intrinsic Value. The next step is easy (but often ignored). You just need to wait for Mr. Market to offer you a price that you can buy the stock for at a sufficient discount to your estimate of its Intrinsic Value. If you don't like today's offering price, just wait a day – Mr. Market will be back the next day … and the next with another offer.

If you have done all of the foregoing correctly then you just need to sit back, monitor the business to make sure that there is no fundamental change to your investment thesis and let time and compounding do their thing or for the market to finally figure it out and value the business properly. While inactivity bordering on sloth is the goal, it doesn't endear value investors to brokers who rely on trading commissions for a living.

My Recent Track Record

2008 was a year that most investors, myself included, would prefer to forget. However, I thought that it was only fair to start tracking my performance in a difficult market. You will be pleased to know that you are taking time out of your day to read the ramblings of a market "guru" who put up a remarkable *minus* 19.6% return in 2008. That said, I was quite happy with my results relative to the major benchmarks as my personal goal is to beat them by an average of 10% per year over the long term. More important than my results for the year was the fact that I managed to keep my wits about me throughout the downturn and loaded up on some stocks that I thought were being given away. My patience was rewarded in 2009 (so far) as I am up 40.7% year-to-date. I would caution you that this 21 month period is insufficient to judge the track record of *any* investor. Three years is an absolute minimum and five years plus in good and bad market conditions is preferable. In other words, the jury's still out on my track record but I like my chances once they reach a verdict.



	Yearly Results				
	McValue Portfolio[1][2]	S&P 500 [2]	McValue Portfolio Outperformance	S&P/TSX[2]	McValue Portfolio Outperformance
2008	-19.55%	-37.00%	17.45%	-32.95%	13.40%
YTD 2009[3]	40.69%	19.26%	21.42%	30.04%	10.64%
Total Return 2008 - 2009[3]	13.19%	-24.86%	38.05%	-12.80%	25.99%
Annual Compounded Return	7.33%	-15.07%	22.40%	-7.53%	14.86%
Standard Deviation[4]	22.94%	23.94%		23.66%	

(1) Based on invested capital (ignoring cash)

(2) With dividends included.

(3) To September 30, 2009

(4) Annualized and based on monthly returns since Jan 1, 2008.

You should know a few things about how I manage my own portfolio. I tend to have a very concentrated or a "conviction" portfolio. The size of my positions in various stocks varies materially based on my level of conviction at the time of purchase and the subsequent market action. Given that I neither use leverage nor do I short-sell, I have the benefit of never needing to sell when Mr. Market disagrees with me. Just as important, I have the temperament to be contrarian when I think that I am right and wait it out without losing my head while others often panic. Unless you can watch your portfolio decline by over 35% in any given year and not lose your cool, you probably shouldn't be in equities.

The benefits of broad diversification make sense for most but I prefer to make a few large bets on a dozen or fewer situations that I think that I understand reasonably well and where I like the risk/reward tradeoff. In other words – my best ideas. This strategy is not for most but I prefer to assume some shorter term volatility in exchange for what I expect will be longer term outperformance. I will not disclose my portfolio weightings or all of my holdings as you can discuss what works for you with your financial advisor (on that note please read the disclosure at the bottom of the last page). But I am happy to continue to share with you my thoughts on certain stocks that I like. Besides, I have to keep a few secrets!

You should also note that I track only the invested portion of my portfolio and ignore my cash position which constantly changes . This has the effect of overstating both my percentage losses in down periods and my percentage returns in up periods but all-in-all I feel that this is a reasonable way of presenting my performance.

Since the beginning of 2008 I am up a modest 13.2% but I like what I own and only wish that I had more time to invest the cash portion of my portfolio that is growing on a daily basis. The bargains are out there. I just need more hours in the day to look for them. Until I do, I would rather stay in cash than do something stupid. Just don't tell Marie France or she will have it spent before the weekend is out.

My Latest Pick

Those that know me best know that I always try and find companies in glamourous industries that make fascinating products so that I can impress people with my knowledge of the subject at cocktail parties. After tossing away many unsuitable candidates I finally found one – Hammond Power Solutions (TSX: HPS.A). And the sexy business is… wait for it … dry-type transformer manufacturing!

Hammond is the leading manufacturer of custom dry-type transformers in North America with an estimated 20% market share. A transformer is essentially an electrical device that transforms voltage – usually “stepping it down” for industrial use. Dry-type transformers use insulation mediums other than oil making them more environmentally friendly and are preferred for indoor applications due to lower fire risks. The types of transformers that you see outside are generally oil-type

A weak economy has already caused softening demand from Hammond’s customers, increased credit risk and lower gross margins due to lower manufacturing utilization. The company also has significant exposure to raw material costs and a declining US dollar – almost a certainty over the medium term given the US administration’s policy actions and America’s ballooning debt. There are many additional risks on this one: an intensely competitive market, illiquidity (the stock trades by appointment), potential environmental remediation claims, a unionized work force, a multiple-voting class share structure that gives the CEO (Bill Hammond) effective control, a manufacturing business based in Ontario, etc.. This one is not for the faint of heart or the someone looking for a short term flip. Please read their Annual Report and latest Annual Information Form - both available at www.sedar.com – to see the many other risks.

So why do I like Hammond? The business was spun out of a larger family business that goes back over 90 years and three generations. My assessment is that management is hard working, pay themselves modestly, have been running the business for many years and they appear to focus on the right things (diversifying distribution and customers, return on net assets, earnings per share). The short term economic environment for Hammond is disastrous (Hammond’s EPS last quarter was only $0.04) but over a longer period of time I think that they will continue to deliver superior returns on equity using minimal leverage. My initial thinking was that this is a commodity business but my thesis has changed. I now believe that their custom orders and focus on short-term delivery give them some pricing power and Hammond’s improving gross margins over the past five years seems to confirm that. Finally, I think that the industry is likely to consolidate like it did in the last recession and Hammond is well positioned to be the consolidator.

Given the price at which bought the stock ($9.00) I think that I have a sufficient margin of safety even if I made a few mistakes in my analysis and should do just fine long term. But it is possible that Hammond will continue to disappoint in the short term given the economic backdrop. With Hammond’s decent balance sheet I think that I have the luxury of time. The stock may well be dead money or decline further but at my acquisition price I think that I am getting good value and with my long-term time frame I am comfortable with the risk/reward. Never forget that *your ultimate return is a function of the price that you pay for a stock!* Stocks in great companies can still be terrible investments if you overpay for them.

***Selected* Current Holdings**

Astral Media
Berkshire Hathaway
Equitable Group
Hammond Power
MacDonald Dettwiler
Nike
TMX Group

***Selected* Former Holdings**

Home Capital
Precision Drilling
Royal Bank
Sprott Inc.
Starbucks
TD Bank
Urbana Corp.

My Most Recent Mistake

Selling early! Value Investors often buy and sell early. The smart ones stick to their guns on the way down (assuming that the investment thesis remains valid) and buy more at better prices. The tough part is learning not to care if the market doesn't agree with you at the time. Remember, you are neither right nor wrong just because the market agrees or disagrees with you at a point in time.

I recently left a significant amount of money on the table by selling my entire holdings in both Starbucks and Home Capital only to watch them appreciate materially after I sold them (by an additional 12% and 37% respectively). They have come off somewhat since then but I still haven't learned not to look after I sell.

Warren Buffett has evolved his thinking on selling since his early private partnership days. Warren currently believes in holding stocks in great companies forever (Fisher/Munger influence). I believe that this is partly a function of the large amount of the capital that he manages and the effect of taxes triggered by a sale. I continue to believe that both SBUX and HCG are trading above my estimate of their Intrinsic Value and I hold almost all of my investments in tax sheltered accounts so I will stay on the sidelines on both names for now. They may well go higher again but *c'est la vie*!

…Til the Next Edition

Assuming that you are still reading I think that this is more than enough of my self-indulgent rant for one session. I would be pleased to hear of any great investment opportunities that interest you or to chat about the dry-type transformer industry, anything in the letter that needs clarifying or investing in general. And remember – a wise many once said to me, "*free advice is usually worth what you pay for it*". *Caveat emptor.*

Best regards,

Michael.

Please note – I am not a broker or financial advisor and no investment advice is given or implied nor am I soliciting any trades or orders. This is a private newsletter intended only for the original recipients and is for educational purposes only. Nothing should be considered a recommendation to buy or sell any stock or security. I ~~strongly recommend~~ insist that you consult with a professional broker or financial planner before you buy or sell any stock or security. I may at times hold positions in any of the stocks mentioned in this newsletter. Investing in securities carries a high degree of risk and you can lose all of your investment money. Past performances do not guarantee future results. Please consult with your own independent tax, business and financial advisors with respect to any investment, including any contemplated investment in any company mentioned. All information contained in this publication must be independently investigated for accuracy. I will not be responsible for the consequences of anyone acting on this purely educational material.